Supreme Court, U.S.
FILED
94 729 OCT 20 1994
OFFICE OF THE CLERK

No. A-189

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1994

GARY E. KRAUSE,
Tax Matters Partner, Barton Enhanced Oil Production Income Fund,
Petitioner-Appellant,

VS.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

PETITION FOR A WRIT OF CERTIORARI

KENNETH M. BARISH, ESQ.
Counsel of Record
REISH & LUFTMAN
11755 Wilshire Boulevard, 10th Floor
Los Angeles, California 90025-1516
(310) 478-5656
Attorney for Gary E. Krause, Tax Matters Partner

Bowne of Los Angeles, Inc., Law Printers (213) 627-2200

46pp

QUESTIONS PRESENTED FOR REVIEW

1. Whether the Tenth Circuit Court of Appeals ("Tenth Circuit") failed to give an appropriate de novo review to the decision of the Tax Court.
2. Whether the Tenth Circuit used an incorrect method in its affirmation of the decision of the Tax Court, because it failed to review the record of the case in its entirety.
3. Whether the Tenth Circuit used an incorrect standard in determining profit motive when it applied the "dominant or primary objective of the venture" test.
4. Whether, as a matter of law, the Tenth Circuit incorrectly concluded that the debt obligations of the Petitioner are not genuine debt and therefore Petitioner's investors should not be

allowed partnership interest deductions under 26 U.S.C. §163.

5. Whether the Tax Court and Tenth Circuit committed egregious errors in rendering their decisions that Petitioner lacked profit motive.

TABLE OF CONTENTS

	Page(s)
QUESTIONS PRESENTED FOR REVIEW	i
OPINIONS BELOW	1
JURISDICTION	1
STATEMENT OF THE CASE	2
REASONS FOR GRANTING THE WRIT	9
I. The Tenth Circuit Used The Wrong Standard Of Review By Failing To Review De Novo The Tax Court's Determination That There Was No Profit Motive.	11
II. The Tenth Circuit Test For Profit Motive Is Contrary To Other Circuits And A True And Direct Conflict On The Issue Exists . .	13
III. The Tenth Circuit's Holding That The Debt Obligations Of The Partnership Are Not Genuine Is Erroneous As A Matter Of Law. . .	22
IV. The Supreme Court Has The Opportunity To Correct An Egregious Error In The Lower Courts.	24

Page(s)

A. Summary of Argument 24

B. The Tax Court And Tenth Circuit Have Committed A Number Of Errors In Their Decisions 28

TABLE OF AUTHORITIES

Page(s)

Anderson v. Bessemer City,
470 U.S. 564 11

Burger v. Commissioner,
809 F.2d 355 (7th Cir. 1987) . . . 16

Campbell v. Commissioner,
868 F.2d 833 (6th Cir. 1989) . . . 16

Carolina's Farm and Power Equipment Dealers v. United States,
699 F.2d 167 (4th Cir. 1983) . . . 14

Clark v. Commissioner,
951 F.2d 1258 (10th Cir. 1991) . . 17

Cornfeld v. Commissioner,
790 F.2d 1049 (D.C. Cir. 1986) . . 17

Evans v. Commissioner,
908 F.2d 369 (8th Cir. 1990) . . . 17

Faulconer v. Commissioner,
748 F.2d 890 (4th Cir. 1984) . 16, 18

Frank Lyon Co. v. United States,
435 U.S. 580, 581 at n. 16, 98 S.Ct. at 1291, 1302 (1978) 12

Hildebrand v. Commissioner,
Tax Court Docket No. 33231-86,
Tenth Circuit Court of Appeals
Docket No. 93-9010, Supreme Court
of the United States Application
No. A-185 . . . . . 3, 4, 9, 27, 34

Page(s)

Hillendahl v. Commissioner,
976 F.2 737 (9th Cir. 1992) 17

Knetsch v. United States,
364 U.S. 361, 365, 81 S.Ct.
132, 134 12

Louisiana Credit Union League v.
United States,
693 F.2d 525 (5th Cir. 1982) . . . 14

Miller v. Commissioner,
836 F.2d 1274, 1277, 10th Cir.
(1988) 12

Narver v. Commissioner,
670 F.2d 855 (9th Cir. 1982) . . . 35

Nickeson v. Commissioner,
962 F.2d 973 (10th Cir. 1992) . 18, 19

Professional Insurance Agents of
Michigan v. Commissioner,
726 F.2d 1097 (6th Cir. 1984) . . . 14

Rice's Toyota World, Inc. v. Commissioner,
752 F.2d 89, 96 (4th Cir. 1985),
rev'g in part, 81 T.C. 184 (1983) . 23

Schley v. Commissioner,
375 F.2d 747 (2nd Cir. 1967) . . . 16

Smith v. Commissioner,
937 F.2d 1089 (6th Cir.
1991) 15, 21, 36, 37, 39, 40

Page(s)

Weir v. Commissioner,
109 F.2d 996 (3rd Cir. 1940) . . . 16

TAX COURT CASES

Abramson v. Commissioner,
86 T.C. 2770 (1986) 35

D.C. Harrington v. Commissioner,
48 T.C.M. 837 (1984) 23

Estate of Baron,
83 T.C. 542, 552 (1984), aff'd.
798 F.2d 65 (2nd Cir. 1986) 20

Estate of Thomas v. Commissioner,
84 T.C. 412, 432 (1985) 20

Ferrell v. Commissioner,
90 T.C. 1154, 1194-1195 (1988) . . 39

Fox v. Commissioner,
82 T.C. 1001, 1021 (1984) aff'd. 798
F.2d (2d Cir. 1986) 20

Friendship Diaries, Inc. v. Commissioner,
90 T.C. 1054, 1064 (1988) 20

Krause v. Commissioner,
92 T.C. 1003 (1989) 22

Levy v. Commissioner,
91 T.C. 838, 853, 871-872 (1988) . 20

Smith v. Commissioner,
91 T.C. 733 (1988). 20

INTERNAL REVENUE CODE OF 1986

	Page(s)
IRC §162	13
IRC §163	3
IRC §165	13
IRC §174	13
IRC §183	17, 24
IRC §6213	2
IRC §6414	2
IRC §6621(b)	3
IRC §6621(c)	3
IRC §6653(a)(1)	3
IRC §6653(a)(2)	3
IRC §6659	3
IRC §6661	3
IRC §7442	2

OPINIONS BELOW

The opinion of the Tenth Circuit is reported at 28 F.3d 1024, and is reprinted in the Appendix attached hereto. The opinion of the United States Tax Court is reported at 99 T.C. No. 7 (1992), and is reprinted in the Appendix hereto. The opinion of the Tax Court on cross-motions for summary judgment relating to whether the obligations of the limited partners of the Wichita are recourse under Internal Revenue Code ("IRC") §465 is reported at 92 T.C. 1003 (1989) and is not reprinted.

JURISDICTION

This Court has jurisdiction to review the judgment of the United States Court of Appeals for the Tenth Circuit entered on June 22, 1994, pursuant to Title 28, United States Code, Section 1254. On

September 14, 1994, Associate Justice Ruth Bater Ginsburg issued an order extending the time for filing of Petition for Writ of Certiorari to and including October 20, 1994.

STATEMENT OF THE CASE

Petitioner Gary E. Krause, Tax Matters Partner, Barton Enhanced Oil Production Income Fund (the "Petitioner"), brings this appeal from the decision of the Tenth Circuit Court of Appeals, which affirmed the decision in the United States Tax Court entered on July 29, 1992. The Tax Court had jurisdiction of the case pursuant to IRC §7442, §6213 and §6414 of the Internal Revenue Code of 1986.

The opinion of the Tax Court on which the decision was based found that the Petitioner was not entitled to deduct

losses incurred by Barton Enhanced Oil Production Income Fund ("Barton"), because the transaction was not entered into with a profit motive. Moreover, the Tax Court held that the debt obligations owed by Barton to Hemisphere Licensing Corporation ("Hemisphere"), were not genuine and did not support interest deductions under IRC §163. Furthermore, the Tax Court held that the additions to tax under IRC §6653(a)(1) and §6653(a)(2), §6659 and §6661 were not applicable. The Tax Court held that the increased rate of interest of Section 6621(c) and its predecessor Section 6621(b) was applicable.

The Tax Court issued a joint opinion with the case of Hildebrand v. Commissioner, Tax Court Docket No. 33231-86, Tenth Circuit Court of Appeals Docket No. 93-9010, Supreme Court of the U.S.

United States Application No. A-185.

This is a complex case that generated 8,361 pages of trial testimony in a trial that spanned fifteen (15) weeks, which included over 1,500 multi-page exhibits, 46 fact witnesses and 28 expert witnesses. Additionally, there are ten limited partnerships which comprise the "Wichita Partnerships." The partnerships were formed during the period 1981 through 1984. Barton, a 1982 partnership, was chosen as a test case for all of the partnerships of the Wichita Partnerships in the Tax Court litigation. This case and the related Hildebrand case are test cases for approximately 2000 cases involving individual limited partners. (Appendix, p. 3.) In total, there is more than $2 Billion in tax at stake in the combined cases. (Appendix, p. 4.)

Barton was formed in 1982 with the Petitioner as its general partner. The primary purpose of the partnership is to (1) acquire and operate producing oil and gas properties, (2) license and apply enhanced oil recovery ("EOR") and microbial enhanced oil technology recovery on these properties, and (3) market chemicals, processes, equipment and research and development service to third-party oil producers for use on their own properties. These partnerships were formed at a time when the United States, along with the rest of the world, were in the midst of the oil-energy crisis. As a consequence of the oil-energy crisis, the price of crude oil rose substantially in a short period of time. The energy-crisis resulted in such events as the formation of the U.S. Synthetics Fuel Corporation

and Congress legislating tax breaks for oil production from the use of EOR.

Primary production of petroleum reservoirs typically recovers 12-15% of the original oil in place ("OOIP"). After the natural reservoir energy in the oil production rate has declined, secondary recovery methods, such as water flooding, are frequently implemented. Secondary methods can usually recover an additional 15-20% of the OOIP. After primary and secondary production, many reservoirs still contain 65% (327 billion barrels) of the OOIP. In a technically feasible reservoir, up to 45% of the remaining oil in place can possibly be recovered using EOR.

This recognition that there were 327 billion barrels of OOIP available for recovery by enhanced oil recovery

techniques, in conjunction with the perception in 1981 of an ever increasing oil pricing scenario, were viewed by the major oil companies and the oil industry in general, to present the circumstances for the generation of substantial economic profit. Similarly, this potential for profit was available to enterprising companies and individuals.

When the Petitioner became interested in EOR, he thoroughly investigated the investment and eventually, after a number of years, decided to enter into licensing agreements with Hemisphere Licensing Corporation ("Hemisphere"), which held proprietary licenses for a group of enhanced oil technologies. Furthermore, he obtained a commitment from Hemisphere to conduct research and development on the technologies in order to determine those

which would best fit the oil producing properties purchased by the Wichita Partnerships.

One of the significant factors in the Petitioner's decision to invest in EOR was the prediction of constantly rising oil prices by the Department of Energy/Energy Information Agency (DOE/EIA).

The business plan of the Wichita Partnerships, an example of which was Barton, is very simple and predicated upon the purchase of oil properties and applying EOR to them.

In order to pursue their business plan, the Wichita Partnerships purchased interests in producing oil and gas properties in Oklahoma, Montana, Illinois, Pennsylvania and California. In addition, tests were conducted in order to determine the applicability of specific EOR

technology licensed from Hemisphere upon the partnership-owned properties.

In consideration for the licensing rights Barton received it paid cash and promissory notes. The total tax write-off for the investment in Barton was 2.32 to 1. These meager tax benefits are the issue of this case

REASONS FOR GRANTING THE WRIT

Petitioner's case is a lead case for a substantial number of cases now pending in the United States Tax Court. This case, along with the companion Hildebrand matter, will decide approximately 2,000 cases. Furthermore, it involves an important question of federal law; namely, the definition of profit motive under the Internal Revenue Code. If the Supreme Court grants review in this case, it will

avert a conflict in the Circuit Courts of Appeals concerning the standard for determining profit motive. The tax deficiencies at issue in connection with the group of related cases are in excess of $2 Billion. Lastly, the case is an opportunity for the Court to correct an egregious error in the lower courts and thereby avert the prejudicial consequences from the incorrect decision by the Tax Court for the large number of taxpayers involved, a good number of whom are elderly and living on retirement and/or fixed incomes.

I. The Tenth Circuit Used The Wrong Standard Of Review By Failing To Review De Novo The Tax Court's Determination That There Was No Profit Motive.

In its opinion, the Tenth Circuit used the "clearly erroneous" standard of review. (Appendix, p. 169.) Furthermore, the Tenth Circuit agreed with the proposition in Anderson v. Bessemer City, 470 U.S. 564 that if the lower court's account of the evidence is plausible in light of the record viewed in its entirety, the Court of Appeals may not reverse. (Emphasis added.)

However, the correct standard for review is that the Appellate Court accepts all factual findings that are not clearly erroneous. And, based on those findings, the Appellate Court reviews de novo the ultimate characterization of the

transaction (emphasis added). See Frank Lyon Co. v. United States, 435 U.S. 561, 581 at n. 16, 98 S.Ct. at 1291, 1302 (1978); Knetsch v. United States, 364 U.S. 361, 365, 81 S.Ct. 132, 134; Miller v. Commissioner, 836 F.2d 1274, 1277, 10th Cir. (1988). By failing to review de novo the characterization of the transaction, the Tenth Circuit has used the wrong standard of review.

Furthermore, the Tenth Circuit failed to review the record in its entirety and rather, only examined "pertinent parts of the record." (Appendix, p. 162.)

As a consequence of the foregoing, the Petitioner and the many taxpayers subject to the decision in the case were not given an appropriate review by the Tenth Circuit.

II. The Tenth Circuit Test For Profit Motive Is Contrary To Other Circuits And A True And Direct Conflict On The Issue Exists.

The Tenth Circuit Court of Appeals stated the test for determining whether the Commissioner possessed the requisite profit objective as, " . . . whether the profit was the dominant or primary objective of the venture." (Appendix, p. 161.) The issue of profit motive and whether a venture is undertaken with a motive for profit is a recurring issue throughout the Tax Code. Thus, for example, trade or business expenses under IRC Section 162, as well as losses under IRC Section 165 are not allowed unless there is a profit motive in the venture. Similarly, research and experimental expenditures under IRC Section 174 are not

allowed unless there is the requisite profit motive. Also, in the context of whether an activity constitutes a trade or business for purposes of the unrelated business income tax, a number of courts have adopted the profit motive test. See Professional Insurance Agents of Michigan v. Commissioner, 726 F.2d 1097 (6th Cir. 1984); Carolina's Farm and Power Equipment Dealers v. United States, 699 F.2d 167 (4th Cir. 1983); Louisiana Credit Union League v. United States, 693 F.2d 525 (5th Cir. 1982). The profit motive question is a very important one which permeates the entire Internal Revenue Code, both on the income and deduction sides of the ledger.

However, the standard used by the various courts, as well as the language used in their decisions, are unclear and contradictory. As one Court commented, we

have been "glutted with tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify." Collins v. Commissioner, 857 F.2d 1383, 1386 (9th Cir. 1988). Thus, the following tests have been used in determining whether there was a profit motive in a transaction:

1. Whether the transaction has any practical effects other than the creation of income tax losses Smith v. Commissioner, 937 F.2d 1089, 1096 (6th Cir. 1991).

2. Whether the taxpayer had a "actual and honest" objective in making a profit. Practically every circuit in at least one opinion, has utilized solely this test. See for example:

1st Circuit: Estate of Power v. Commissioner, 736 F.2d 826 (1st Cir. 1984)

2nd Circuit: Schley v. Commissioner, 375 F.2d 747 (2nd Cir. 1967)

3rd Circuit: Weir v. Commissioner, 109 F.2d 996 (3rd Cir. 1940)

4th Circuit: Faulconer v. Commissioner, 748 F.2d 890 (4th Cir. 1984)

6th Circuit: Campbell v. Commissioner, 868 F.2d 833 (6th Cir. 1989)

7th Circuit: Burger v. Commissioner, 809 F.2d 355 (7th Cir. 1987)

8th Circuit: Evans v. Commissioner, 908 F.2d 369 (8th Cir. 1990)

9th Circuit: Hillendahl v. Commissioner, 976 F.2 737 (9th Cir. 1992)

10th Circuit: Clark v. Commissioner, 951 F.2d 1258 (10th Cir. 1991)

D.C. Circuit: Cornfeld v. Commissioner, 790 F.2d 1049 (D.C. Cir. 1986)

3. Whether the profit objective was the primary or dominant objective in the transaction.

The primary or dominant motive standard was used by the Tenth Circuit in the case at bar. It is also a standard used by many other circuits in resolving profit motive issues. However, there is nothing in IRC §183 or its legislative history

requiring that the profit motive be predominant. Faulconer supra.

As may be seen from the foregoing, there is a split between the circuits concerning the definition of profit motive. In fact, within the same circuit and in actuality within the same opinion, the Court of Appeals have used language which is inconsistent. That is true of the language in the case at bar, (Appendix pp. 161 & 163). It is similarly true in the Tenth Circuit decision in Nickeson v. Commissioner, 962 F.2d 973 (10th Cir. 1992). In Nickeson the Appellate Court articulated two different and separate tests for whether a taxpayer had a profit motive. Nickeson, supra. At one juncture, the Tenth Circuit stated that the test is "whether the activity was undertaken or continued in good faith with the dominant

hope and intent of realizing a profit." Id. at 976. However, at other points it states that the test is ". . . an actual and honest profit objective . . ." Id. at 976-978.

The presence of significant tax benefits (that may have influenced the investors in entering into the transaction) should not result in the loss of the associated tax benefits if the investor, in fact, has an actual and honest profit objective apart from the tax benefits (assuming the transaction is not a sham). This fact has been recognized by the Tax Court in a number of situations where Congress has made available particular tax benefits with the specific intent of providing investors special incentives to enter into investments that they may not otherwise enter into. See

e.g., Snow v. Commissioner, 416 U.S. 500, 1503 (1974); Levy v. Commissioner, 91 T.C. 838, 853, 871-872 (1988); Friendship Diaries, Inc. v. Commissioner, 90 T.C. 1054, 1064 (1988); Estate of Thomas v. Commissioner, 84 T.C. 412, 432 (1985); Estate of Baron, 83 T.C. 542, 552 (1984), aff'd. 798 F.2d 65 (2nd Cir. 1986), Fox v. Commissioner, 82 T.C. 1001, 1021 (1984) aff'd. 798 F.2d (2d Cir. 1986).

Furthermore, the Tax Court has recognized that oil and gas activities are commonly recognized as congressionally encouraged by tax incentives. Smith v. Commissioner, 91 T.C. 733 (1988).

In such instances where congress has acted to give tax incentives to investors, it is submitted that the more relaxed standard for determining profit motive of the Sixth Circuit should be the litmus

test. Thus, the profit motive standard in those situations should be whether the transaction had any practical effects other than the creation of income tax losses, and the inquiry must be conducted from the vantage point of the taxpayer at the time the transaction occurred, rather than with the benefit of hindsight Smith, supra at 1096.

With some 2,000 cases pending related to the case at bar, involving more than $2 Billion, the potential for conflict of decision on the same facts is definite and inevitable. An early and definitive ruling by the Supreme Court will save much judicial time and expedite the resolution of a large group of cases before the Tax Court. Also, without a definite and firm statement from this Court concerning the test for profit motive, it is impossible

for taxpayers to know if they are complying with the mandates of the tax laws.

III. The Tenth Circuit's Holding That The Debt Obligations Of The Partnership Are Not Genuine Is Erroneous As A Matter Of Law.

In a mere one paragraph in it's Opinion, the Tenth Circuit agrees to the Tax Court's vague, summary and erroneous conclusion that the partnership's interest deductions should not be allowed because the obligations to which they relate are not genuine. These conclusions are contrary to the law and should be overturned.

The obligations of Petitioner to Hemisphere were fully recourse in both principle and interest. Krause v.

Commissioner, 92 T.C. 1003 (1989). Furthermore, even if a partnership is not operated to make a profit, a point which Petitioner does not concede, the interest on recourse debt is deductible. Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 96 (4th Cir. 1985), rev'g in part, 81 T.C. 184 (1983); D.C. Harrington v. Commissioner, 48 T.C.M. 837 (1984).

The law allows for taxpayers to take tax deductions for interest paid on genuine debts. Even if the venture does not have a profit motive, interest is still deductible. By not allowing the Petitioner the interest deduction in the case at bar, the Tax Court has, in effect, denied the numerous investors similarly situated to Petitioner proper tax deductions.

IV. The Supreme Court Has The Opportunity To Correct An Egregious Error In The Lower Courts.

A. Summary of Argument.

The opinion by the Tax Court that the Petitioner did not have the requisite profit motive in partnership activities was totally erroneous and did not take account of the complete facts presented during the lengthy trial. The legal analysis and standard used by the Tax Court of whether the Petitioner had a profit motive are flawed, since the Tax Court did not discuss, nor take into consideration, significant relevant factors recognized for cases of this type under the regulations under IRC §183.

Of the nine factors enumerated for consideration in the regulations under IRC §183, the Tax Court inappropriately

emphasized two factors in rendering its Opinion: 1. The supposed heavy promotion and marketing on the basis of projected tax benefits and inaccurate information regarding the Enhanced Oil Recovery ("EOR") technology . . . and (2) the financial structure of the fees and royalties that the partnerships agreed to pay. (Appendix, p. 108.) Moreover, the Tax Court's factual analysis with respect to those two factors upon which it incorrectly focused was clearly erroneous.

The Tax Court's Opinion was in error with regard to the issue of a profit objective in the following conclusions, inter alia, reached by it:

1. The technology licensed from Hemisphere Corporation had no significant economic value;

2. The license fees paid to

Hemisphere by Petitioner were excessive, abnormally structured and not typical;

3. Oil price projections used by the Petitioner were of questionable validity;

4. The assumptions used in the Private Placement Memorandum were questionable;

5. The basis of the license fee paid by Petitioner to Hemisphere was the number of partnership units sold and not upon the number of barrels of oil which could be recovered;

6. The license fees were structured to give substantial write-offs;

7. The license fees between Petitioner and partnership were not based on arms-length negotiations; and

8. There was no basis for optimism about the value of the technology.

The Tax Court's Opinion also is in error in its conclusion that accrued interest deductions of the Petitioner are disallowed due to the non-genuine nature of the underlying debt obligations. Through its decision in regard to the cross-motions for partial summary judgment, the Tax Court has adjudged that the limited partners were personally liable on the debt of the Wichita Partnerships on a recourse basis. In such instance, the debt must be genuine and should not be disregarded.

The Tax Court in rendering a consolidated Opinion with the Hildebrand case, has commingled the facts of two separate cases and has allowed the facts of the Hildebrand case to taint its decision with regard to the Petitioner's case.

B. The Tax Court And Tenth Circuit Have Committed A Number Of Errors In Their Decisions.

The Tax Court rendered its decision in this case without understanding Barton's business plan. Furthermore, the Tax Court did not understand the consideration paid by Petitioner for the license acquired from Hemisphere Licensing Corporation, or that the risky venture that was contemplated had "fail-safes" and a definite realistic opportunity for profit.

In the 1970s and early 1980s, the United States experienced the "oil crisis," which was perceived as a threat to the national security. In response to this situation, President Carter publicly announced a new national goal to achieve energy independence within a decade. This was a multifaceted goal that would combine

an increase in the domestic supply of crude oil together with creation of new sources of energy to decrease reliance upon fossil fuels. The government ultimately developed the U.S. Synthetic Fuels Corporation, which had a budget of around $19 Billion. The Synthetic Fuels Corporation ultimately funded nothing, spent a lot of money and went out of business.

Also, there were numerous research and development facilities set up by the government for direct funding of research and development in the private sector. Literally billions of dollars were either spent directly by the government or provided through tax incentives to accelerate synthetic fuel, enhanced oil recover and fossil energy research. Although the government had multifaceted

plans, it was believed that enhanced oil recovery would be the first to be successful.

To foster enhanced oil recovery, tax incentives, such as the Tertiary Oil Incentive Program, were enacted. It was always conceived that the private sector would perform the enhanced oil recovery projects. Furthermore, the government was attempting to accelerate technology, and hopefully, accelerate the development of enhanced oil recovery technologies in the private sector.

The price of oil rose dramatically in the late 1970s and early 1980s, eventually peaking in 1981 at approximately $40.00/bbl. This dramatic increase in the price of energy caused, in part, the double digit inflation the United States saw in the early 1980s. Equally important

as the actual rise in the price of oil was the perception by the government, oil producers and investors, that the price of oil was on a never ending upward spiral. The Department of Energy and Energy Information Administration, (DOE/EIA) in its 1980 report to Congress predicted that the price of oil, based on its mid-case scenario, would be $100.00 per barrel in 1990. Also, oil companies were making similar predictions of the price of oil and making corporate decisions on those forecasted prices.

In 1986, a number of factors came together to cause a precipitous drop in the price of oil from its 1985 level of approximately $35/barrel to its low in 1986 of $10/barrel. Only in the last few months of 1987 did prices start to recover. In 1988 prices dropped again.

While the Tax Court's opinion recognized the energy price hysteria that existed in the 1970s and early 1980s, and the reason an investor would want to invest in EOR technology, (Appendix, pp. 7-11, 74), it failed to fully understand the business plan of the Wichita Partnerships. This business plan is predicated upon the purchase of oil properties and applying EOR to them in order to increase production and cash flow. Each partnership has, as one of its objectives, to purchase oil wells and then actually purchase properties, with the proceeds of the partnership offering as well as through a reinvestment plan. The basic business objective is to increase the rate and volume of production from these properties through an EOR research and development program. The research and

development program is to be conducted by Hemisphere, or one of its related entities.

Petitioner has admitted that the investment in EOR was risky, but the well thought out business plan called for reducing of the risk through:

(1) The purchase of already producing properties;

(2) The use of promissory notes, due and payable in 15 years to allow cash flow to purchase additional oil properties for lower prices, as opposed to paying current royalties;

(3) Fixing the royalty at today's dollars, yet paying the royalty in inflated dollars;

(4) Requiring substantial research on EOR from Hemisphere, the licensor; and

(5) Certain moderate tax benefits.

In entering into the license agreement with Hemisphere, the petitioner engaged in extensive negotiations, and in fact, he negotiated a number of protective provisions for the Wichita Partnerships that are different from those of the Manhattan Partnerships (the Hildebrand case related herein), and that are more favorable to the partnerships. This was recognized by the Tax Court in its Opinion, Appendix pp. 102 & 103. In addition, the Petitioner successfully negotiated substantial changes for Barton in 1982, which enhanced the business plan and made the investment more favorable for limited partners, in comparison with the 1981 Wichita Partnerships.

The negotiations between the Petitioner and Hemisphere were at arm's length and

when two parties dealing at arm's length assign a certain value to property, and when that value has economic significance to each of the parties,the value assigned by the parties is very persuasive evidence of its fair market value. Narver v. Commissioner, 670 F.2d 855 (9th Cir. 1982); Abramson v. Commissioner, 86 T.C. 2770 (1986). Despite this well-known legal maxim, the Tax Court held that the value set through the negotiations was not the fair market value. Furthermore, the Tax Court held the technology license rights had negligible value. This conclusion of the Tax Court of fair market value should have been reviewed de novo by the Tenth Circuit; yet, the Tenth Circuit merely affirmed the Tax Court's conclusion under the clearly erroneous standard. (Appendix, p. 169.)

In a number of different regards, the Tax Court used inappropriate hindsight to analyze Petitioner's investment. Smith v. Commissioner, supra. Examples of the use of inappropriate hindsight in the Tax Court Opinion, includes all of its conclusions concerning the economics of this investment. Thus, the Court inappropriately judges the investment structure based on contemporary views.

One of the erroneous conclusions upon which the Tax Court put great emphasis is that the license fee paid by Barton to Hemisphere was based on the number of partnership units sold.

The license fees for the rights Barton obtained from Hemisphere were based on a per barrel basis, not on the number of partnership units sold. Under the technology license with Hemisphere, Barton

obtained use rights, as well as distribution rights. License fees for the use rights were calculated in terms of a royalty rate at $1.00 per barrel of incremental oil production. Furthermore, in terms of a percentage royalty rate, at the time of execution of the agreement in 1982, the royalty rate was 2.9%. Notably, as the price of oil increased, as was expected by all government publications, the royalty rate as a percentage, would decrease.

Moreover, the Tax Court's emphasis upon this factor is misplaced. In discussing an investment structure where it was alleged that the amount of fees were dependant on the number of partnership units sold, as was the case with the Tax Court, the Sixth Circuit in Smith v. Commissioner, supra, at 1094 stated:

> We are not as impressed as the Tax Court Judge was with this reportedly unusual method or procedure, or contingent arrangement, because many times promoters, salespersons, or professionals, such as attorneys or brokers or engineers, may receive a greater or lesser fee based on success of the venture or undertaking involved.

Another example of the inappropriate use of hindsight relates to the conclusion that it was unreasonable for the Petitioner to rely upon the government's published price projections.

The business plan for the Petitioner's partnership was, in large part, predicated upon the Doe/EIA price projections

published in 1981. The Tax Court held that it was unreasonable for the Petitioner to rely upon these oil price projections, citing as its authority, Ferrell v. Commissioner, 90 T.C. 1154, 1194-1195 (1988). This holding was a large part of the basis of the decision that the Petitioner lacked profit motive in the investment. The Circuit agreed with this conclusion.

However, it is submitted that this is an incorrect superimposing of hindsight upon an investment made in reliance upon the government's published declarations of policy and price projections. Smith v. Commissioner, supra.

Moreover, the Tax Court's hindsight review of these oil price projections and whether or not it believes them to be valid is not the important standard.

Rather, petitioner's subjective belief that the oil price projections were reliable is the paramount consideration. Smith v. Commissioner, supra.

One of the factors the Tax Court thought was particularly relevant in its determination of lack of profit objective, was "heavy promotion and marketing on the basis of projected tax benefits and inaccurate information regarding EOR technology." (Appendix, p. 108.) However, this is not a correct conclusion. The total tax write-off for this investment was 2.32 to 1. Furthermore, the Offering Memorandum for the Barton Partnership is largely devoid of any promotional information regarding the tax write-offs. Moreover, the tax opinion portion of the Offering Memorandum is devoted to the most

mundane of tax aspects of partnership status, basis, dissolution, etc.

An important error reached by the Tax Court was that the EOR technology licensed by the Petitioner had insufficient value. Eventually, the number of technologies which were licensed to Barton by Hemisphere totalled approximately 125. Included in the portfolio of technologies were a number of technologies which admittedly were of commercial importance. (Appendix, p. 110.)

One example of an important technology licensed by Barton from Hemisphere is the "horizontal drill." This technology was developed by an independent engineering firm under subcontract to Hemisphere. It is also a technology which is commercially used and has been recognized by experts in this field as a revolutionary advancement

in enhanced oil recover research. However, this technology was not referred to in the Tax Court's Opinion, although there was extensive testimony as to its importance to the oil industry and EOR.

The extent of the testimony and documents provided to the Tax Court for its review perhaps was overwhelming. On the issue of the technology, the Petitioner submitted an extensive report prepared by the National Institute for Petroleum and Energy Research ("NIPER"), the former U.S. Department of Energy, Bartlesville, Oklahoma, Energy Technology Center. The report was not only an analysis of two of the technologies licensed from Hemisphere by the Petitioner, but represented an extension and summary of research that was done at NIPER between the years 1983 and 1986,

under a cooperative agreement with the Department of Energy. The two technologies which were the subject of the research at NIPER and the report submitted to the Court were, without contradiction, considered to be spectacularly revolutionary in the area of EOR.

Included in the NIPER report were details of the conclusions concerning the economic potential of each of these two technologies. The summary contained in the report concluded that there is a reasonable expectation of recovering 4 billion barrels of oil through use of these two broadly applicable technologies. The potential income from projects using these technologies, based on the assumed oil predictions used by the U.S. government for 1981 is $1.7 Billion to $17 Billion in 1979 constant dollars or $15.5

Billion to $46.6 Billion in forecasted real (inflated) dollars.

In the trial of this matter, the Petitioner showed the tremendous potential for profit that could be obtained from the EOR technology license from Hemisphere. It also showed the relative success of the portfolio in a short period of time.

The Tax Court recognized that " . . . a portion of the purported EOR technology . . . might have reached some state of development by the years in issue and (. . . additional EOR technology might in subsequent years be developed and become valuable) . . ." (Appendix, p. 110.) How the Tax Court can thereafter hold that the value of the technology was insignificant is unclear.

Another aspect of the business plan of the Petitioner which was discounted by the

Tax Court is that the Petitioner conducted substantial activities to fulfill Barton's business plan. In order to pursue the business plan, the Petitioner purchased interests in producing oil and gas properties in Oklahoma, Montana, Illinois, Pennsylvania and California. Furthermore, in each instance, the field was purchased from an independent oil company.

The extent of business activities of the Petitioner in purchasing oil producing properties was matched by Petitioner's activities in the use of the technology licensed from Hemisphere on its fields. The fields had substantial tests of EOR technology, starting in 1983.

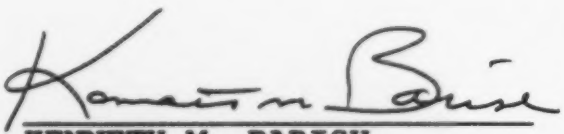
Unfortunately, oil prices plummeted in 1986. At that time, Barton, like the entire oil industry, curtailed research and development in EOR. Nevertheless,

during the three year period between 1983 and 1986, Barton helped support development of the Hemisphere technology with NIPER, purchased interest in six oil fields, conducted tests of EOR technology on those fields and was on the verge of proving at least two of the Hemisphere technologies on the partnership's oil fields. During the three year period 1983 through 1986, Barton accomplished all of the aforementioned tasks. Unbelievably, despite the laudatory accomplishments of Petitioner and Barton, the Tax Court held that the Petitioner lacked profit

objective. As shown by the above, this is clearly an erroneous conclusion.

Dated: October 20, 1994

Respectfully submitted,

By: 

KENNETH M. BARISH
Counsel of Record
Reish & Luftman
Attorney for Petitioner
Gary E. Krause,
Tax Matters Partner